ECO 407
Competing Views in Macroeconomic Theory and Policy

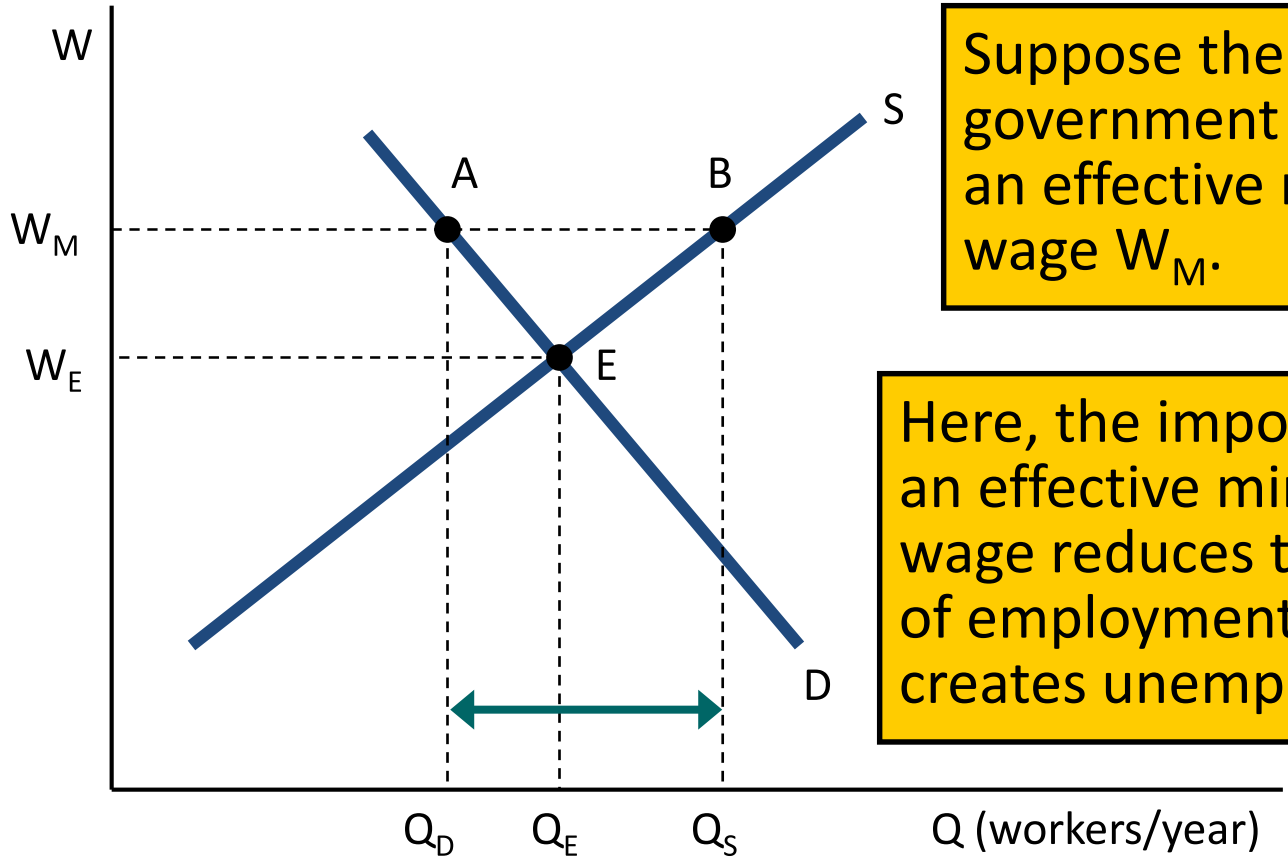
Lecture 1
The Market System and the Public Sector

Positive vs. Normative Economics

- ***Positive*** economics means ***factual*** or ***descriptive***
  - To find out why things happen
- ***Normative*** economics studies how to make things better
  - Focuses on what ***ought to be*** and not on what it is
  - ***Ideology*** is an important determinant
  - And making things better, but for ***whom***?
- ***Positive*** economics is supposed to be void of ***ideology***
  - But is that possible? For example, what happens when the minimum wage is raised?
  - Economics is ***not*** a ***science*** like physics or chemistry, but a ***political*** exercise (Chang)

Possible Effect of Minimum Wage

In the absence of government intervention, equilibrium is at price W_E and quantity Q_E.

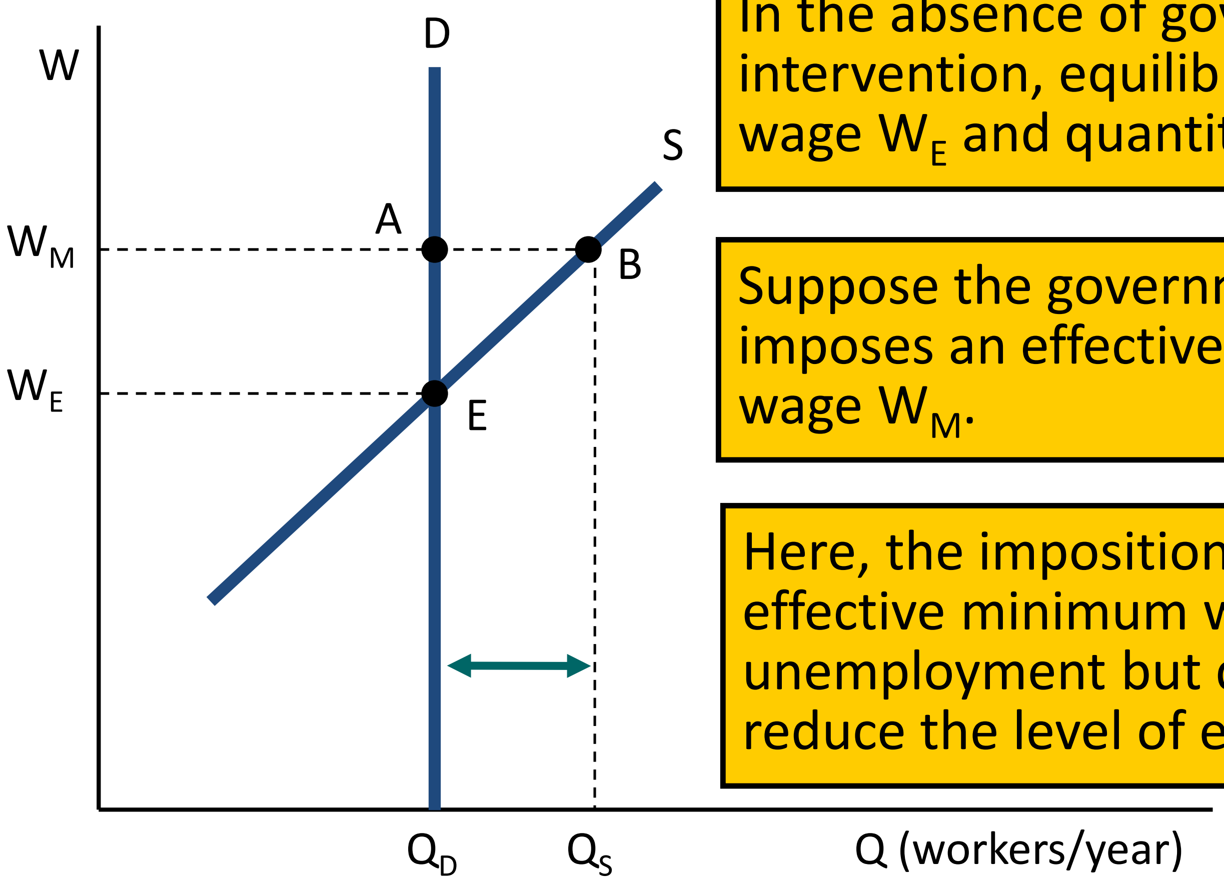


Suppose the government imposes an effective minimum wage W_M.

Here, the imposition of an effective minimum wage reduces the level of employment and creates unemployment.

Possible Effect of Minimum Wage (cont'd)

Let's assume now that the demand for labour is vertical.



In the absence of government intervention, equilibrium is at wage W_E and quantity Q_D.

Suppose the government imposes an effective minimum wage W_M.

Here, the imposition of an effective minimum wage creates unemployment but does not reduce the level of employment.

The Market vs. the Public Sector

- Should we use the ***market*** or the ***public sector*** — i.e., the ***state*** — to solve socio-economic problems?

- According to market-advocates, the market makes the “best” allocation of resources
  - The market outcome is an ***equilibrium*** (i.e., it cannot be improved by the action of market forces)
  - But is this equilibrium an ***optimum***?
  - Can state intervention improve this market outcome?

- What is the role of the state in the determination of economic outcomes?

The Market vs. the Public Sector (cont'd)

- The state has always been at the centre of the study of economic development

- For ***modernization*** theory, the state is benevolent and pluralistic
  - The state complements and promotes markets for the benefit of society

- For ***Marxism***, the state is a reflection of class conflict
  - The state complements and promotes markets according to the interests of the ruling classes
  - The state acts as the ***collective*** capitalist

An Extreme Pro-Market View

- The view of the role of the state in economic development changed with the emergence of ***neoliberalism*** (i.e., of the ***Washington Consensus***)
- Neoliberals see the state as being based on the pursuit of individual self-interest through ***political*** as opposed to ***market*** means
  - Source of rent-seeking and corruption
- Two propositions followed:
  - The state should be confined to a minimal level of activity
  - Economic development is an inevitable consequence of the reliance on market forces

A More Moderate Pro-Market View

- A less extreme pro-market position accepts that government intervention ***may*** improve outcomes when there is ***market failure***

- ***Market failure*** refers to two possible situations:
  - Something prevents the emergence of a market
  - For some reason, markets do not produce an optimum

- Existence of ***market failure*** is viewed as a ***necessary*** but not ***sufficient*** condition for government intervention
  - It is argued that sometimes government intervention might worsen the situation

Sources of Market Failure

- Lack of well-defined property rights
- High income-concentration
- Existence of public goods
- Existence of externalities
- Oligopolistic tendencies
- Asymmetric information
- Cases of "merit goods"
- Existence of coordination failures

Do Free Markets Lead to Welfare Gains?

- Market advocates argue that everyone is paid according to his/her contribution in the process of production
- Is Pareto optimality necessarily the best outcome?
  - There is no such thing as pure positive economics
- If a given income distribution is considered wrong, maximizing on this basis may lead to a worse outcome
- Neoclassical economists tend to ignore income distribution as a matter of concern
- The production of wrong goods (“bads”) is also dismissed on grounds of consumer sovereignty

Chang: *There Is No Such Thing as a Free Market*

- Free-marketeers argue that markets allocate resources most efficiently
  - Therefore, markets need to be free
  - Government interference creates inefficiencies
  - People must be left "free to choose"

- But free markets do ***not*** exist
  - Every market has rules and boundaries that restrict freedom of choice
  - Government is always involved
  - Free-marketeers are as ***politically*** motivated as anyone
  - ***Economic*** decisions are not separable from ***politics***

Chang: *Kicking Away the Ladder*

- Mainstream economists present a misleading account of the history of capitalist development
  - All presently developed countries actively used ***industrial policies*** (i.e., government intervention) to promote infant industries
  - Once they developed, they tried to pull away from competitors by controlling the transfer of technology and forcing developing countries to open their markets

- IFIs and donor countries put great pressure on developing countries to adopt “good policies” and create “good institutions”
  - ***Good policies*** → market liberalization
  - ***Good institutions*** → pro-market institutions

Should Governments Intervene?

- Given the following context, what would your policy recommendation be?

> ***Consider a set of policy interventions targeted on a loosely-defined set of market imperfections that are rarely observed directly, implemented by bureaucrats who have little capacity to identify where the imperfections are or how large they may be, and overseen by politicians who are prone to corruption and rent-seeking by powerful groups and lobbies.*** (Dani Rodrick, "Normalizing Industrial Policy")

- Would you say that these are some of the valid reasons why governments should not intervene in the economy?

Should Governments Intervene? (cont'd)

- Rodrick, however, was referring to government intervention in areas such as education, health, social security, and macroeconomic stabilization.
- Therefore, the debate is not so much about ***whether*** the government should intervene in the economy, but rather about ***how*** it should do it.
- ***Market imperfections*** on which the theoretical arguments for industrial policy are based ***do exist*** and ***are*** often pervasive.
- ***Market failures*** that ***industrial policy*** targets are in markets for credit, labour, products, and knowledge.

Some Questions for Discussion

- Why should market outcomes be accepted at face value? What does the evidence suggest about market efficiency?
- Is economic efficiency an end in itself? Or is economic efficiency a means towards an end?
- Should the economy determine society? Or should society determine the economy? In other words, is society embedded in the economy or is the economy embedded in society?
- Is economic growth an end in itself?
- Shouldn't the main objective be improving the well-being of the population? If so, can this objective be achieved by free markets and economic growth alone?